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TAGS: ECON EFIN EINV PGOV SY
SUBJECT: SUBSIDIES: A GROWING RISK FACTOR FOR THE SYRIAN ECONOMY

REF: A. DAMASCUS 0111
¶B. 06 DAMASCUS 01696
¶C. DAMASCUS 00087
¶D. 06 DAMASCUS 00290
¶E. DAMASCUS 00403

Classified By: CDA Michael H. Corbin for reasons 1.4 b/d

¶1. (C) Summary: In spite of a modestly strengthening economy, the SARG faces increasing fiscal pressure to reduce the billions of dollars it currently expends on subsidies. The SARG's budget deficit is increasing dramatically because of the dual challenge of declining oil revenues and growing public expenditures, particularly subsidies. The increasing cost of subsidies - exacerbated by the influx of Iraqi refugees ) is challenging the SARG's ability to hide or defray the costs through accounting tricks or spending hard currency reserves. Rumors are circulating in Damascus that following the upcoming elections the SARG will try to relieve some fiscal pressure by instituting a long-promised subsidy reduction plan. The SARG may choose to delay such an action, however, because of regime concerns about rising inflation and popular discontent, as well as regional political tensions. End Summary.

¶2. (C) DECLINING OIL REVENUES: Independent sources indicate that Syria's overall macro-economic situation has improved modestly over the past two years (Ref A). Nevertheless, Syria has several looming economic challenges, including a potential decline in government revenues linked to falling oil production. Historically, the SARG,s three main sources of revenue are oil exports, state-owned enterprise (SOE) surpluses, and tax collection. None of these revenue sources is showing significant growth, while revenues from oil production and state-owned enterprises are actually waning. Oil production, which currently accounts for 45 percent of government revenue, is declining by an estimated seven to eight percent per year. Contacts also report that while a few SOE's, like Syriatel, are producing profits, most are costing the government money because they have heavy production losses and suffer from high-levels of corruption. Regime officials have publicly admitted that public sector losses of SOE,s that distribute a wide range of agricultural, energy, and industrial subsidies was USD 2.6 billion in 2006, up from an estimated USD 2 billion in 2005. Finally, while the government instituted a series of tax reforms in 2007, contacts assert that the ongoing lack of financial transparency and accountability continues to stymie significant increases in tax collection.

¶3. (C) PUBLIC EXPENDITURES INCREASING: While government revenues are faltering, public expenditures are increasing.

In 2006, contacts estimated that subsidies and public sector losses cost the government more than USD six billion ) more than 60 percent of the USD 9.9 billion budget (Ref B). Although initial 2006 estimates placed the cost of the single largest subsidy, imported diesel, at USD 2.5 billion, regime officials have now publicly stated the costs was much higher at USD 3.3 billion. In 2007, the SARG's fiscal burden associated with subsidies is continuing to mount. The Director General of Syria's state-owned company in charge of the distribution of oil products publicly estimated that the diesel subsidy will reach more than USD 3.6 billion in 2007, but his estimate was far lower than other estimates by regime officials, including Deputy Prime Minister for Economic Affairs and Finance Minister Mohammad Hussein, who have been publicly quoted in the past few months saying that the diesel subsidy is expected to reach more than USD five billion this year. This means that even if the cost of no other subsidies increased in 2006, the total cost of subsidies and public sector losses could cost the government nearly USD eight billion or 69 percent of the total USD 11.76 billion expenditures projected in the SARG's 2007 budget. Contacts add that the cost of other subsidies, including electricity, are also increasing. Regime figures estimate electricity subsidies cost the government roughly USD 500 million per year, and as SARG officials now claim electricity demand increased by 14 percent in 2006, the cost of these subsidies is also mounting.

¶4. (U) INCREASING DEMAND FOR SUBSIDIES EXACERBATED BY IRAQI REFUGEES: Over the past year, there has been growing concern among average Syrians that the more than one million Iraqi refugees in Syria are getting free use of subsidies intended for them. Although similar public comments by SARG officials peaked in January in conjunction with the temporary tightening of its Iraqi immigration policy, Syrian officials

continue to make announcements that Iraqis are a burden on government subsidies. Government-owned newspapers estimated that Iraqis in Syria consume more than USD 250 million worth of subsidized diesel per year, while Deputy Prime Minister for Economic Affairs, Abdullah Dardari recently said that Iraqis were a significant cause of the increased electricity demand noted above. Syrian economists also state that Iraqi refugees are a burden on government expenditures, and assert that this burden is not offset by Iraqi purchasing power.

¶5. (C) BUDGET DEFICIT GROWING: Although Syrian economists acknowledge the widening gap between revenue and expenditures, the SARG has not accurately reported this financial burden in its 2007 budget. The SARG has historically underestimated the amount of subsidies and other expenditures in its budget, using accounting tricks such as understating the selling price of oil to cover its unaccounted spending (ref C). The SARG clearly underestimates the subsidies cost in the 2007 budget, only allocating USD 500 million for "price stabilization" or subsidies when they admitted to spending USD 3.3 billion for oil subsidies alone in 2006. As a result, contacts affirm that subsidies will increase the budget deficit far above the USD 1.69 billion already anticipated by the SARG for this year. In fact, contacts note that 2007 will be the first year the SARG spends more on subsidies of diesel than the income it receives from oil exports. SARG officials themselves have begun to make public statements that the oil deficit alone will grow by eight-fold this year, from USD 157 million in 2006 to USD 1.3 billion in 2007. Contacts speculate that this means the SARG might need to start spending down it significant hard currency reserves (currently estimated at more than USD 20 billion) to cover the increasing deficit.

¶6. (C) NEW RUMORS THAT SARG WILL REDUCE SUBSIDIES POST REFERENDUM: Business contacts and Syrian economists have asserted that the regime is increasingly concerned about the growing burden of subsidies. Furthermore, they have relayed rumors that the regime is going to implement a long-promised subsidies reduction plan after the May 27 presidential referendum. The plan is expected to include a phased lifting

of subsidies, modulated cash payouts to citizens at different income levels, and at least initially, an increase in the diesel price from 14 cents/liter to 40 cents/liter. According to contacts, this is the same plan regime officials put on show in 2005 and again in 2006 to rationalize domestic prices, abolish black market trading in commodities, and decrease the incidence of cross-border smuggling through which the SARG claims it loses a large portion of its supply every year. The SARG did take moderate steps in January 2006 to reduce the subsidies and price controls on cement and some oil derivative products such as heavy fuel oil and gasoline (Ref D). Nevertheless, the larger plan was never implemented, with regime officials who had discussed its implementation publicly excoriated afterwards.

¶7. (C) SARG CONCERNED ABOUT INFLATION AND PUBLIC DISCONTENT: Regardless of the pressure on the SARG, however, some business contacts are skeptical that the SARG will move forward with the subsidies reduction as planned. Contacts point to the current rates of inflation which are eroding Syrian's purchasing power as adding to the regime's natural hesitance to move forward with reform. Public discontent towards inflation has grown over the past year (Ref E). The added potential inflationary effect of raising subsidies is also significant. Independent Syrian economist Samir Seifan asserts that as 35 percent of diesel consumption is for domestic use and 45 percent for transportation, the average consumer would experience significant price increases if the government were to reduce its current level of price subsidy. This leads many contacts to believe that despite the heavy fiscal burden, the SARG will likely choose to sustain the most important subsidies, like diesel, at current levels.

¶8. (C) Comment: The rapidly widening gap between revenues and expenditures is increasing fiscal pressure on the SARG to reduce subsidies. Nevertheless, the SARG could very well once again delay action. Its relatively strengthened macro-economic situation, in part, makes that more likely. The SARG tends to test the waters for any prospective policy change by first circulating rumors like those currently making the rounds about a pending move to lift subsidies. As the level of internal resistance become apparent, the SARG often reverses course before ever having committed itself publicly to any change. In this case, because the SARG's chronic problem with rising inflation could turn acute if the price of diesel were to increase, it may well forgo any subsidy reform, choosing the higher premium it attaches to its own stability over the less immediate economic benefits. Furthermore, the regime is unlikely to undertake such a potentially problematic internal change while the situation in Lebanon, including the outcome of the Hariri tribunal, remains uncertain.
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